

Message Text

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ACTION ARA-10

INFO OCT-01 ISO-00 SP-02 AID-05 EB-04 NSC-05 RSC-01

CIEP-01 TRSE-00 SS-15 STR-01 OMB-01 CEA-01 CIAE-00

COME-00 FRB-01 INR-05 NSAE-00 XMB-02 OPIC-03 LAB-01

SIL-01 PA-01 PRS-01 USIA-06 IO-10 AGR-05 L-02 H-01

DODE-00 SWF-01 TAR-01 /088 W
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R 181655Z NOV 74

FM AMEMBASSY SAN JOSE
TO SECSTATE WASHDC 8602
INFO AMEMBASSY GUATEMALA
AMEMBASSY MANAGUA
AMEMBASSY PANAMA
AMEMBASSY SAN SALVADOR
AMEMBASSY TEGUCIGALPA

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E.O. 11652: N/A

TAGS: EFIN, CS

SUBJECT: ANALYSIS OF COSTA RICA'S CREDIT RESTRICTIONS

REF: (A) SAN JOSE 4301

(B) SAN JOSE A-126 OF 10/2/74

SUMMARY. COSTA RICA'S CENTRAL BANK ANNOUNCED ON NOVEMBER 12
NEW CREDIT REGULATIONS FOR THE BANKING SYSTEM THAT WILL
PROHIBIT CREDIT ON A LIST OF IMPORTED LUXURY AND SEMI-LUXURY
GOODS AND WILL REQUIRE LARGE DOWN PAYMENTS (GENERALLY
40 PERCENT) AND SHORT REPYMENT PERIODS (18-24 MONTHS) ON
SIMILAR GOODS PRODUCED OR ASSEMBLED DOMESTICALLY OR WITHIN
THE CENTRAL AMERICAN COMMON MARKET (CACM). THE RESTRICTIONS
APPLY TO SUCH ITEMS AS AUTOMOBILES, RADIOS, TELEVISION SETS,
PHONOGRAPHS, MAJOR KITCHEN AND LAUNDRY ROOM APPLIANCES, WATCHES,
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AND FOREIGN TRAVEL. THIS MESSAGE DISCUSSES THE REACTION TO THOSE

RESTRICTIONS AND ANALYSES THEM IN RELATION TO THE CURRENT ECONOMIC SITUATION. END SUMMARY.

1. REACTION - AFFECTED PORTIONS OF THE BUSINESS COMMUNITY ARE IN A STATE OF SHOCK. THERE ARE PREDICTIONS OF PRODUCTION DECLINES OF 50 PERCENT IN SOME LINES, OF LARGE-SCALE LAYOFFS AND BUSINESS FAILURES -- "A MORTAL BLOW FOR COMMERCE." HOW IS THE COSTA RICAN CONSUMER WHO USED TO BUY A REFRIGERATOR WITH NO DOWN PAYMENTS AND 36 MONTHS TO PAY AT \$12 PER MONTH GOING TO COME UP WITH A 40 PERCENT DOWN PAYMENT? MOST MERCHANTS RECOGNIZE THAT STEPS HAD TO BE TAKEN TO REDUCE IMPORTS BUT THEY WOULD HAVE PREFERRED Milder MEASURES, OR POSTPONEMENT UNTIL AFTER CHRISTMAS, OR MEASURES THAT WOULD AFFECT SOMEONE ELSE'S BUSINESS. THE MOST POSITIVE REACTION CAME FROM THE HEAD OF THE CHAMBER OF INDUSTRIES WHO SAID: "THE MEASURES SHOULD NOT HAVE SURPRISED ANYONE." THE CENTRAL BANK HAD NO CHOICE BUT TO DEFEND THE COLON." COSTA RICA MUST ENTER INTO A STAGE OF MODERATION OF CONSUMPTION."

2. THE MONETARY SITUATION - FINANCIAL MEASURES TAKEN BY THE CENTRAL BANK -- HIGHER INTEREST RATES AND SURVEILLANCE OVER CAPITAL OUTFLOWS -- STOPPED THE OUTFLOW OF CAPITAL THAT HAD BROUGHT COSTA RICA'S RESERVES TO A CRISIS LEVEL IN SEPTEMBER. FOLLOWING IMPOSITION OF THESE MEASURES IN MID SEPTEMBER, THERE HAD EVEN BEEN A MODERATE INFLOW OF CAPITAL FOR ABOUT FOUR WEEKS BUT THIS INFLOW REPORTEDLY HAD CEASED BY MID-OCTOBER LEAVING RESERVES STABILIZED AT ABOUT THE \$35 MILLION LEVEL. THIS WAS NOT A SATISFACTORY LEVEL (ONE MONTH'S IMPORTS OR ABOUT \$60 MILLION WOULD BE CONSIDERED A MINIMUM COMFORTABLE LEVEL BY COSTA RICAN STANDARDS) AND WITH THE CONTINUING TRADE IMBALANCE, THE CENTRAL BANK OBVIOUSLY CONCLUDED THAT FURTHER STEPS WERE WARRANTED.

3. THE TRADE SITUATION - COSTA RICA'S FUNDAMENTAL BALANCE OF PAYMENTS PROBLEM THIS YEAR (AS OPPOSED TO THE TEMPORARY PROBLEM OF CAPITAL OUTFLOW WHICH WAS RELATED TO INTEREST RATE DIFFERENTIALS) DERIVES FROM AN ESTIMATED 59 PERCENT GROWTH IN THE VALUE OF IMPORTS. IMPORTS ARE EXPECTED TO LIMITED OFFICIAL USE

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TOTAL \$700 MILLION THIS YEAR, \$262 MILLION ABOVE 1973. ONLY SOME \$35 MILLION OF THE INCREASE IN IMPORTS IS DIRECTLY ATTRIBUTABLE TO INCREASED PETROLEUM COSTS, AN AMOUNT THAT IS MORE THAN OFFSET BY COSTA RICA'S INCREASED EARNINGS ON ITS EXPORTS WHICH ARE EXPECTED TO BE SOME \$80 MILLION HIGHER THAN LAST YEAR.

THE BARE TRADE FIGURES SUGGEST THAT COSTA RICA HAS BEEN ON A SPENDING SPREE, BUT FURTHER ANALYSIS DIMINISHES THAT

IMPRESSION. PROJECTIONS MADE BY THE EMBASSY ON THE BASIS OF NINE MONTHS DATA SUGGEST THAT INFLATION IN THE PRICE OF COSTA RICA'S IMPORTS HAS AMOUNTED TO 40 PERCENT THIS YEAR. (A PORTION OF THIS IS IMPORTED INFLATION AND THE REST IS THE EFFECT OF THE APRIL DEVALUATION OF THE COLON). THUS, THE VOLUME OF IMPORTS THIS YEAR WOULD APPEAR TO HAVE INCREASED ONLY ABOUT 19 PERCENT (59 MINUS 40). MUCH OF THIS 19 PERCENT MAY NOT HAVE BEEN FOR DIRECT INCREASES IN CONSUMPTION BUT TO BUILD UP INVENTORIES, AS MOST BUSINESSES HERE -- CAUGHT IN AN INFLATIONARY PSYCHOLOGY -- HAVE BUILT UP EXCESSIVE STOCKS OF RAW MATERIALS, SEMI-FINISHED, AND FINAL GOODS.

4. OVERALL EFFECT ON THE ECONOMY - COSTA RICA'S NEW CREDIT RESTRICTIONS WILL CLEARLY HAVE A FAVORABLE IMPACT ON THE BALANCE OF PAYMENTS PROBLEM BOTH BY REDUCING IMPORTS AND BY DIMINISHING ANY INCIPIENT TENDENCY TOWARD CAPITAL FLIGHT THAT MIGHT HAVE INTENSIFIED IN THE ABSENCE OF INDICATIONS THAT THE GOVERNMENT IS WILLING TO TAKE STRONG MEASURES TO AVOID ANOTHER DEVALUATION AT THIS TIME. BUT, THE EFFECT ON IMPORTS MAY BE DELAYED OWING TO THE LARGE INVENTORIES ALREADY IN THE COUNTRY.

5. THE EFFECT ON THE OVERALL LEVEL OF ECONOMIC ACTIVITY WILL CLEARLY BE NEGATIVE. IF THE ECONOMY WERE OVERHEATED BY A DEMAND-PULL TYPE INFLATION A DAMPENING EFFECT WOULD BE SALUTARY, BUT MUCH OF THE INFLATION HERE IS THE RESULT OF EITHER ACTUAL INCREASES IN THE PRICES OF IMPORTS OR "BOOK-KEEPING" INCREASES IN THE LOCAL CURRENCY PRICE OF IMPORTS THAT RESULTED FROM LAST SPRING'S DEVALUATION OF THE COLON. THE OVERALL LEVEL OF DEMAND IN THE ECONOMY DOES NOT APPEAR TO HAVE BEEN EXCESSIVE, EVEN THOUGH THERE HAS BEEN AN EXCESSIVE DEMAND FOR IMPORTS IN TERMS OF WHAT THE BALANCE OF LIMITED OFFICIAL USE

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PAYMENTS CAN AFFORD.

6. IN FACT, KNOWLEDGEABLE OBSERVERS HERE BELIEVE THAT THE ECONOMY HAS BEGUN TO DEVELOP SIGNS OF SOFTNESS. DOMESTIC SALES AND SALES TO THE CACM COUNTRIES ARE SAID TO HAVE BEEN SLIPPING FOR THE PAST COUPLE OF MONTHS. IF THE ECONOMY IS INDEED HEADED INTO A RECESSION, THE CENTRAL BANK'S CREDIT RESTRICTIONS WILL HELP TO NUDGE IT ALONG THAT PATH, AND MAY RESULT IN THE CENTRAL BANK GETTING MORE THAN A FAIR SHARE OF THE BLAME.

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7. EFFECTS ON THE COMMERCIAL SECTOR - PROBABLY THE ALARM
EXPRESSED BY SOME SEGMENTS OF COMMERCE IS WARRANTED. THE
CREDIT RESTRICTIONS COME AT AN INOPPORTUNE TIME (JUST
PRIOR TO THE CHRISTMAS SELLING SEASON), AND CATCH MANY FIRMS
IN A POSITION OF EXTREME VULNERABILITY. MANY MERCHANTS HAVE
BUILT UP EXCESSIVE INVENTORIES OF IMPORTED GOODS (E.G. THE
CHEVROLET DISTRIBUTOR HAS AN EIGHT MONTH INVENTORY) AND
MANY ASSEMBLERS AND MANUFACTURERS HAVE EXCESSIVE INVENTORIES
OF COMPONENTS AND RAW MATERIALS. THESE STOCKS WERE BUILT
UP TO BEAT WHAT APPEARED TO BE EVER-RISING PRICES, OR IN
FEAR OF COAL OR DOCK STRIKES IN THE U.S., AND NOW THAT PRICES
HAVE LEVELLED OFF OR, IN THE CASE OF SOME INPUTS, HAVE FALLEN,
AND LOCAL DEMAND IS SLACKENING, SUCH HIGH STOCKS APPEAR TO
BE TOTALLY OUT OF LINE WITH SALES PROSPECTS. GIVEN THE
HIGH COST OF CARRYING THESE INVENTORIES, A RISE IN BANK-
RUPTCIES IS THE LIKELY RESULT, UNLESS THE CREDIT RESTRICTIONS
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ARE EASED OR MERCHANTS FIND WAYS TO CIRCUMVENT THEM.

8. SOCIAL EFFECTS - THE GREATEST BURDEN OF THE CENTRAL BANK'S CREDIT RESTRICTIONS WILL FALL ON THE MIDDLE CLASS. THE POOR ARE NOT IN A POSITION TO BUY THE "BIG TICKET" CONSUMER DURABLES AFFECTED BY THE RESTRICTIONS. THE MORE PROSPEROUS ELEMENTS OF SOCIETY CAN EITHER PAY CASH OR EVADE THE RESTRICTIONS. IF THEY OWN COFFEE "FINCAS" OR OTHER AGRICULTURAL ENTERPRISES ELIGIBLE FOR SUBSIDIZED CREDIT (AS MANY DO), THEY WILL BE ABLE TO BORROW AT 8-10 PERCENT FOR THEIR FARM OPERATIONS AND DIVERT MONEY THAT WOULD OTHERWISE HAVE BEEN USED IN THOSE OPERATIONS TO BUY AUTOMOBILES AND TV SETS. IF THEY DO NOT HAVE ANY SUCH HOLDINGS, PERSONS WITH STRONG CREDIT RATINGS WILL BE ABLE TO GET PERSONAL LOANS THAT WOULD NOT BE AVAILABLE TO THE LESS PROSPEROUS WHO CAN ONLY GET LOANS SECURED BY THE MERCHANDISE TO BE PURCHASED.

9. CONCLUSIONS - WHETHER THE CENTRAL BANK WAS WISE IN IMPOSING SUCH STRONG CREDIT RESTRICTIONS AT THIS TIME OR WHETHER IT WOULD HAVE BEEN WISER TO BORROW MORE MONEY TO SUPPORT FOREIGN EXCHANGE RESERVE LEVELS DEPENDS ON A FORECAST OF WHAT THE FUTURE HOLDS. IF COSTA RICA'S BALANCE OF PAYMENTS PROBLEM IS PERCEIVED TO BE A TEMPORARY ONE THAT WILL IMPROVE NEXT YEAR, A CASE COULD BE MADE FOR DEPENDING MAINLY ON INCREASED BORROWING (SOME ADDITIONAL BORROWING WILL BE REQUIRED IN ANY CASE), SUPPLEMENTED PERHAPS BY Milder CREDIT RESTRICTIONS. IF, ON THE OTHER HAND, ONE EXPECTS THAT COSTA RICA'S BALANCE OF PAYMENTS PROBLEMS WILL BE JUST AS BAD, OR PERHAPS WORSE, NEXT YEAR, ONE WOULD HAVE TO SAY THAT IT IS WISE TO TAKE STRONG MEASURES NOW RATHER THAN BORROW EVEN MORE MONEY ABROAD AT HIGH INTEREST RATES THEREBY INCREASING COSTA RICA'S DEBT BURDEN FOR NO PURPOSE OTHER THAN TO POSTPONE THE DAY OF RECKONING.

10. ON BALANCE, THE ACTION TAKEN BY THE CENTRAL BANK APPEARS TO HAVE BEEN PRUDENT. COSTA RICA'S RESERVE POSITION WAS PRECARIOUS AND THERE WERE NO RELIABLE SIGNS THAT THE BALANCE OF PAYMENTS WILL BE BETTER NEXT YEAR. MOREOVER, IN THE ABSENCE OF FIRM MEASURES, THERE WAS A LIMITED OFFICIAL USE

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RISK OF FURTHER LOSS OF CONFIDENCE THAT COULD HAVE LED TO A RENEWAL OF CAPITAL FLIGHT AND FORCED A DEVALUATION (WHICH THE GOVERNMENT WANTED TO AVOID AS EXPLAINED IN REF B).

11. IT MAY BE THAT THE CENTRAL BANK COULD HAVE ACCOMP-

LISHED THE SAME PURPOSE WITH A Milder AND MORE SHARPLY
FOCUSSED ACTION. AFTER ALL, IN TERMS OF THE BALANCE OF
PAYMENTS, NO PURPOSE IS SERVED BY PREVENTING, OR MAKING
DIFFICULT, THE SALE OF MERCHANDISE THAT HAS ALREADY BEEN
IMPORTED INTO THE COUNTRY (UNLESS ONE EXPECTS THE MER-
CHANDISE TO BE A RE-EXPORTED -- A STEP THAT COULD NOT BE
RULED OUT UNDER PRESENT CIRCUMSTANCES). PERHAPS THE
RESTRICTIONS COULD HAVE BEEN MADE TO APPLY TO MERCHANDISE
NOT YET IMPORTED; OR MAYBE IMPORT QUOTAS, OR EVEN A
TEMPORARY EMBARGO, ON IMPORTS OF LUXURY GOODS WOULD HAVE
BETTER ACCOMPLISHED THE DESIRED PURPOSE WITHOUT JEOPARDIZING
THE SOLVENCY OF MERCHANTS AND THE JOBS OF THEIR EMPLOYEES.
USE OF QUOTAS WOULD REQUIRE, OF COURSE, IMPOSITION OF PRICE
CONTROLS (WHICH ARE IN ANY CASE PENDING IN THE LEGISLATIVE
ASSEMBLY) TO PREVENT QUOTA RECIPIENTS FROM REAPING WINDFALL
PROFITS ON GOODS MADE SCARCE BY THE QUOTA SYSTEM. IN ANY
SUCHPROGRAM, THERE WOULD ALSO BE A PLACE FOR CREDIT
RESTRAINT, BUT PERHAPS IN Milder FORM THAN THAT ADOPTED
BY THE CENTRAL BANK.

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